



**TOWARDS FINANCIAL INCLUSION
IN EAST JAVA: ASSESSMENT OF THE ISSUES FROM
THE PERSPECTIVE OF ISLAMIC MICROFINANCE OF
THE CLIENTS AND EXPERTS**

BY

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**A thesis submitted in fulfilment of the requirement for the
degree of Doctor of Philosophy (Business Administration)**

**Kulliyyah of Economics and Management Sciences
International Islamic University Malaysia**

SEPTEMBER 2018

ABSTRACTS

Even though the Indonesian financial industry is growing exponentially, a significant population under poverty remains financially excluded from the mainstream financial facilities. Even when financial services are available, certain low-income group may exclude using conventional micro-financing on religious grounds. This indicates that religious values appear to be an important issue to shape the attitudes of the rural clients who are predominantly Muslim. This study was based on the concern for appraising the appropriateness of Islamic microfinance to enhance financial inclusion in Indonesia. The first objective is to examine the main factors that hinder micro-entrepreneurs from accessing financing from mainstream financial services in Indonesia's province of East Java. The second is to examine factors that affect Muslim clients' behaviour in participating in Islamic microfinance, in this case BMT (*Baitul Maal wat Tamwil*). The third is to investigate Islamic microfinance practitioners and *Shari'ah* scholars' views on the issues and challenges of promoting BMT in Indonesia. The variables used in the study consists of a theoretical framework comprising five barriers to accessing finance, namely affordability barrier, eligibility barrier, accessibility barrier, availability barrier and religious barrier. Decomposed Theory of Planned Behaviour is also used as a research framework for accessing clients' participation in Islamic microfinance. Relevant information was collected from BMT clients in East Java using a survey questionnaire and interviews with Islamic microfinance experts. The Structural Equation Modelling (SEM) was used as main analytical tool. The study revealed that the five variables are indeed factors that contribute to the financial exclusion of micro-entrepreneurs in mainstream financial services. In terms of clients participating in BMT, among three main beliefs, only perceived behavioural control (PBC) was found to have a positive and significant impact on clients' participation in BMT. With regard to antecedents' influence on their beliefs, relative advantage, awareness, normative beliefs and self-efficacy were significant. The qualitative findings are consistent with the main issues and challenges of promoting BMT identified in the literature, particularly human capital, regulation, role of the government and lack of capital issues.

ملخص البحث

يبدأ أن الصناعة المالية الإندونيسية تنمو بشكل كبير، إلا أنه لا يزال هناك عدد كبير من السكان يعيش تحت وطأة الفقر مهمّشًا في الحياة عن المرافق المالية السائدة. وعندما تكون الخدمات المالية متاحة، قد تستثني بعض فئات الدخل المنخفض طوعاً من استخدام التمويل الأصغر التقليدي بسبب أسسها الدينية. هذا يشير إلى أن القيم الدينية تبدو واحدة من القضايا المهمة لتشكيل مواقف العملاء الريفيين الذين هم في الغالب من المسلمين. وهذه الدراسة تهتم بتقييم ملاءمة التمويل الأصغر الإسلامي لتعزيز الاندماج المالي في إندونيسيا. ومن ثمّ، تتم متابعة الأهداف المحددة في هذه الدراسة، الهدف الأول دراسة العوامل الرئيسية التي تعوق الوصول إلى التمويل من الخدمات المالية الرئيسية في مقاطعة جاوا الشرقية في إندونيسيا، والهدف الثاني دراسة العوامل التي تؤثر على سلوك العملاء المسلمين في المشاركة في التمويل الأصغر الإسلامي، على وجه التحديد مؤسسة بيت المال والتمويل (BMT) Baitul Maal wat Tamwil، والهدف الثالث التعرف والتحقيق لممارسي التمويل الأصغر الإسلامي وعلماء الشريعة حول قضايا وتحديات تعزيز BMT في إندونيسيا. أما عوامل المتغيرات المستخدمة في الدراسة فتمثل في الأطر النظرية لحمس حواجز للوصول إلى التمويل؛ مثل حاجز القدرة على تحمل التكاليف، وحاجز التأهل، وحاجز إمكانية الوصول، وحاجز التوفر والحاجز الديني. بالإضافة إلى ذلك تستخدم النظرية المتحللة للسلوك المخطط كإطار بحثي للوصول إلى تصورات العملاء في التمويل الأصغر الإسلامي. وقد تم جمع المعلومات ذات الصلة من بعض عملاء BMT في مقاطعة جاوا الشرقية بإندونيسيا باستخدام استبيان المسح وكذلك تم إجراء المقابلات الشخصية مع بعض خبراء التمويل الأصغر الإسلامي. فضلاً عن ذلك استخدمت الدراسة نموذج المعادلة الهيكلية (SEM) Structural Equation Modeling بوصفها أداة كمية وأسلوب التحليل الأساسي. وقد كشفت الدراسة أن المتغيرات الخمسة التي تم تحديدها تعدّ من العوامل الأساسية التي تساهم في الاستبعاد المالي لمراكز القروض الصغرى في الخدمات المالية السائدة. وأما من حيث العملاء المشاركين في BMT، من بين ثلاثة معتقدات رئيسية، وجد أن التحكم السلوكي المدرك (PBC) وحده هو الذي يؤثر تأثيراً إيجابياً وكبيراً على مشاركة العملاء نحو BMT. وفيما يتعلق بتأثير السوابق على معتقداتهم الرئيسية، وجد أن الميزة النسبية، والوعي، والمعتقدات المعيارية، والكفاءة الذاتية لها تأثير كبير. والدراسة تظهر من الجانب النوعي المشار إليه أن هناك اتساقاً مع القضايا والتحديات الرئيسية المتعلقة بتشجيع نظام BMT الذي تم تحديده في المؤلفات، وبشكل رئيسي رأس المال البشري، والتنظيم، ودور الحكومة، وقلة القضايا الرأسمالية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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*This dissertation is dedicated to my parents and family
for continuous support, patience and prayer.*

ACKNOWLEDGMENTS

Alhamdulillahirabbil'amin, all praise be upon Allah *Subhanahu wa ta'ala* for His blessings, mercy and infinite bounties during completing this dissertation and throughout my life. Without His consent, this dissertation would have been impossible to complete. Peace and blessings always be upon our beloved Prophet Muhammad *Sallallahu alaihi wasallam* who has been sent as the role model for all humankind.

I am most indebted to my supervisor Assoc. Prof. Dr. Dzuljastri Abdul Razak for the continuous support of my PhD study, for his patience, motivation, and immense knowledge. His guidance helped me in the research and writing of this dissertation. My sincere thanks also goes to my co-supervisor, Assoc. Prof. Dr. Adewale Abideen Adeyemi, for his supervision and corrections, as well as thoughtful suggestions. I gratefully acknowledge Assoc. Prof. Dr. Mustafa Omar Mohammed and Dr. Roslily Ramlee for their insightful comments and encouragement during my PhD viva and proposal defence.

My sincere gratitude also goes to the Rector and the Deputy Rector of Universitas Darussalam Gontor for enabling me to continue my further studies. Thanks to the Dean of Economics and Management Faculty, Head of Management Department as well as my colleagues, all academic and administrative staff who have provided necessary support during my study.

This dissertation will be difficult to complete without the support of the data collection team. Thanks to Bpk. Dumairi (BMT Maslahah Sidogiri Pasuruan), Bpk. Ahmad Junaidi (UGT Sidogiri Cab.Malang), Ibu Mashitoh (Kanindo Syariah Jatim), Bpk. Ahmad Hudaifah (BMT Muda Jatim, Surabaya) dan Ustadz Suyoto Arif (BMT Lantansa, Ponorogo) for granting me in administrating of the questionnaire, and all their staffs involved for helping during my data collections. Thanks also to Ustadz Khoirul Umam (BMT Latansa), Dr. Mohammad Mahbubi Ali (IAIS), Dr. Raditya Sukmana (UNAIR), Dr. Mashyudi Muqorobbin (BMT-UMY), Dr. Irfan Syauqi Beik (BAZNAS) and Dr. Sigit Pramono (SEBI) for their time and valuable information given during the interview sessions.

I would like to thank my wonderful family, my father, Bonasir Bin Salim who has motivated me to pursue my dreams and my mother Hartinah Binti Kasran who has never forgotten me in her prayer. Although they lack access to higher education, their sacrifice for their children is remarkable. Thanks also to my sister, Widya Nurmalasari and my younger brother, Romi Firdausi for consistently supporting me during my studies.

My special thank goes to my beloved wife, Lilik Sugiati for her patience and perseverance. My daughter, Zahrah Nadhira and my son Ahmad Yusuf Maulana have been sources of my happiness and motivation.

Last but not the least, I would like to thank my close friends Ronald, Ahmad Ompo, Muhammad Fany, Muhammad Ghani, Muhammad Shulthoni, Muhammad Bahrul, Muhammad Sholahuddin, Dimas Wiranata, Hidayatul Ihsan, Irfan Hakim, Muhammad Naim, Muhammad Asmy, Anwar AP, Abdel Ghani, Fouad Amin, Dr. Weni and all those who cannot be mentioned in this small space but have contributed to my success.

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LIST OF ABBREVIATIONS

ACC	Accessibility
ADB	Asian Development Bank
AFF	Affordability
AMOS	Analysis of Moment Structures
AVL	Availability
AWR	Awareness
BDNI	Bank Dagang Negara Indonesia
BI	Bank Indonesia (Central Bank)
BIK	Bina Insani Kamil
BKD	Bank Kredit Desa (Village Credit Bank)
BMM	Baitul Mal Muamalat
BMT	Baitul Maal wa Tamwil
BMI	Bank Muamalat Indonesia
BPS	Biro Pusat Statistik (Indonesia Statistics)
BPR	Bank Perkreditan Rakyat (Rural Bank)
BPRS	Bank Perkreditan Rakyat Syariah (Islamic Rural Bank)
BRI	Bank Rakyat Indonesia
CFA	Confirmatory Factor Analysis
CFI	Comparative Fit Index
CGAP	Consultative Group to Assist the Poor
COM	Compatibility
CPX	Complexity
CSR	Corporate Social Responsibility
CU	Credit Union
DTPB	Decomposed Theory of Planned Behavior
EFA	Exploratory Factor Analysis
FC	Facilitating Condition
GDP	Gross Domestic Product
GNP	Gross National Product
ICMI	Ikatan Cendekiawan Muslim Indonesia (The Indonesian Association of Muslim Intellectuals)
IDR	Indonesian Rupiah
IFC	International Finance Corporation
INKOPSYAH	Induk Koperasi Syariah
ITB	Institut Teknologi Bandung
LDKP	Lembaga Dana Kredit Desa (Rural Credit Fund Institutions)
KMO	Kaiser-Meyer-Olkin
KUR	Kredit Usaha Rakyat (Subsidized Credit for Micro Enterprises)
MASS	Microfinance Access and Services Survey
MFIs	Microfinance Institutions
MI	Modification Indices
MSMEs	Micro Small Medium Enterprises
MUI	Majelis Ulama Indonesia (Indonesia Ulama Council)
NB	Normative Beliefs

NGO	Non Government Organization
OJK	Otoritas Jasa Keuangan (Financial Services Authority)
PBC	Perceived Behavioral Control
PINBUK	Pusat Inkubasi Usaha Kecil (Incubation Centre for Small Entreprises)
ProFI	Promotion of Small Financial Institutions
RA	Relative Advantage
RMSEA	Root Mean Square Error of Approximation
Rp	Rupiah
SHA	Syariah
SHGs	Self Help Groups
SLF	Self-Efficacy
SN	Subjective Norms
TPB	Theory of Planned Behavior
TRA	Theory of Reasoned Action
UNC	Uncertainty
UNDP	United Nation Development Program
USD	United States Dollar
VIF	Variance Inflation Factor

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

In 2010 the World Bank¹ reported that 1.2 billion people live in poverty (corresponding to less 1.24 dollar/day) across the globe which is around 20.6% of the population. However, most live in Muslim majority countries with more than 50% of their population living below the poverty line (Obaidullah and Khan, 2008; Shirazi and Amin, 2009). Meanwhile, in the context of South East Asian Countries, Indonesia plays an important role in economics and politics due to its huge human and physical resources. Although Indonesia is a rich country with abundant natural resources, many Indonesians still live under the poverty line. In 2010, 18.6% of its total population was considered very poor with earning below US\$1.25 per day. However, the percentage will increase to about 46.12% when earned US\$2 per day applied (World Bank, 2013). Barber (2008) labelled it the 'stickiness' of poverty experienced by most poor families in Indonesia. In this regard, poverty continues across generations when the poor have no opportunity to access required the resources necessary to exit poverty such as financial capital, education or networks.

With regard to this issue, the Indonesian government has undertaken various pro-poor programs in its effort to reduce poverty. Giving more attention to the importance of financial inclusiveness in empowering micro-small enterprises (MSEs), is a recent program aimed at increasing access to credit for low-income groups involved in small business (Sembiring, 2008). Microenterprises are indispensable to

¹ See <http://povertydata.worldbank.org/poverty/home/#>

Indonesia as they play a major role in sustaining the foundation of the national economy. 98 percent of the total number of enterprises are microenterprises (BPS, 2008)². Although more than 51 million microenterprises are employing some 89.3 percent of the total labour force, their contribution to economic growth remains relatively small compared to medium and large enterprises. This shows that the quality of growth and development of their business is low and hence there is needed to identify the factors that prevent them from expanding their business.

Demirguc-Kunt et al. (2008) identified financial exclusion as the main factors that may hinder growth and development of micro and small enterprises. Barriers to accessing finance may prevent output to reach its maximum capacity and contribute to slower growth. World Bank data shows that the proportion of loans given by banks to microenterprises was 16% of total loans while large enterprises received 47.1% (World Bank Enterprise Survey, 2009).

Demirguc-Kunt et al. (2008) identified some of the barriers to accessing financial services frequently faced by poor micro-entrepreneurs as physical access, eligibility, affordability, and lack of appropriate products and services. Meanwhile, the UK special task force classified financial exclusion into supply side barrier (i.e. non-availability of suitable products, physical barriers and non-eligibility on account of documentation issues) and demand side barrier (i.e. lack of financial literacy and financial capability, psychological and cultural barriers) (Shankar, 2013).

The importance of financial inclusion for economic development cannot be ignored as empirical evidence showed a significant correlation between higher financial inclusion and lower poverty and income inequality (Park and Mercado,

² Indonesia's *Badan Pusat Statistik* (BPS) is a non-departmental government institute of [Indonesia](#) who is responsible to conduct statistical surveys.

2015). The two categories of financial exclusion are voluntary and involuntary exclusion (Demirguc-Kunt et al., 2008). Voluntary financial exclusion refers to a person or business that has access to financial services but does not need to use them. Involuntary financial exclusion refers to a person or business that has no access to financial services but might need to use financial services.

With regard to promoting financial inclusion, the development of microfinance institutions (MFIs) is viewed as a tool to combat financial exclusion (Shanker, 2013). These institutions are an effective tool for bringing up the poor by providing them credit to create self-employment opportunities (Mall and Mishra, 2013). A substantial number of empirical studies show a strong causal relationship between the development of the microfinance institutions (MFIs) and poverty alleviation through microenterprise development (Khandker, Samad and Khan, 1998; Eclouf, 1999; Afrane, 2002). Although many studies of microfinance concluded the positive impact on poverty alleviation, some researchers questioned the credibility of microfinance as an effective tool against poverty. Morduch (1998), for example, claimed microfinance clients were the better-off among the poor. While Kono and Takashi (2010) found selection biases lead to overestimation of the impact of microcredit. Further, IRTI (2007) revealed that institutions charged fixed and high interest rate.

However, the successes of conventional microfinance institutions (MFIs) in reducing poverty have inspired the development of Islamic microfinance institutions. Islamic MFIs offer interest-free financial services that are in line with the *Shariah*. They offer different products and serve as an alternative to the conventional model. Islamic microfinance has been developed to accommodate the demands of the Muslim society seeking alternatives to financing that are in line with the *Shariah*. This is because the interest rate charged by conventional MFIs is considered usury (*riba*)

which is prohibited by Islam (Karim et. al., 2008). Based upon unique characteristics of the Islamic MFIs, Ahmed (2002) argues that Islamic MFIs can perform better compared to conventional banks. He opines that the Islamic teachings that guide Islamic microfinance institutions improve solidarity and social capital among the clients.

1.2 PROBLEM STATEMENT

The presence of more than fifty-thousand various type of MFIs (Hamada, 2010) and the considerable number of informal money lenders illustrates the degree of poverty and demand for microfinance services in Indonesia. Statistics in Indonesia reported that around 28 million people live under the poverty with 4.8 million poor people in East Java (BPS, 2014). Since 15.42% of Indonesia's total population³ live in East Java, they contributed significantly to the national poverty level. The significant number of the poor in the country including East Java relies heavily on the informal sector for their livelihood with microenterprises concentrating on the agriculture and trading sectors. These real sector activities continue to be central to Indonesia's economic development strategy for the poor, and their development has potential to provide income growth and poverty alleviation.

Regarding the poverty issue, numerous governmental programs seek to increase access to financial services through microfinance programs. These include the liberalisation of financial regulations followed by the establishment of the People's Rural Bank (BPR – *Bank Perkreditan Rakyat*, specialised microfinance bank for serving the microenterprise in the rural area), and launching the People's Business

³ According to BPS data, in 2013 Indonesia's population was 248 million with 38 million living in East Java.

Credit Program (*KUR-Kredit Usaha Rakyat*, a special loan program to solve collateral issues faced by microenterprises).

Despite these efforts, a large number of micro-entrepreneurs have difficulties accessing credit. According to data of Bank Indonesia, in East Java, credit allocated to micro-small medium enterprises (MSMEs) is dominated by medium enterprises with around 65 percent of total credit, followed by small enterprises with 29 percent while microenterprises receive only 6 percent of total credit allocated to this segment (World Bank, 2011). This indicates that microenterprises have limited access to financial services which may prevent it from achieving maximum capacity. Such conditions will affect millions of poor people particularly in East Java (World Bank, 2011). The question is what factors hinder their access to financing from financial services? In this context, the study thus aims to empirically examine the variables that hinder customers from accessing financing in East Java province, Indonesia.

In relation to the above-stated issues, identifying barriers to accessing finance is an important step in increasing financial inclusion that will impliedly lead to decreased poverty. The common barriers to access are affordability (high service charge and interest rate), complicated eligibility (inflexible collateral and complicated document requirement), accessibility (physical access), availability or lack of financial product features (financial product provided not to all segments), and the religious factor (Demirguc-Kunt et al., 2008). A study in Nigeria conducted by Adewale et al. (2012) confirmed that eligibility and affordability (classified as involuntary financial exclusion barriers), financial complacency, cultural capital and religious consideration (included as voluntary financial exclusion barriers) are perceived as hampering microentrepreneurs' to access financial services. These barriers exclude lower income groups from accessing financing services from conventional banks.